

2-1-2008

Recent Developments in Individual Taxation

Annette M. Nellen

San Jose State University, annette.nellen@sjsu.edu

E. Cook

J. Horn

M. Musacchio

Follow this and additional works at: https://scholarworks.sjsu.edu/acc_fin_pub



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

Annette M. Nellen, E. Cook, J. Horn, and M. Musacchio. "Recent Developments in Individual Taxation" *The Tax Adviser* (2008): 82-85.

This Article is brought to you for free and open access by the Accounting and Finance at SJSU ScholarWorks. It has been accepted for inclusion in Faculty Publications by an authorized administrator of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.

RECENT DEVELOPMENTS IN INDIVIDUAL TAXATION

BY ELLEN COOK, JONATHAN HORN, MICHELLE MUSACCHIO, AND ANNETTE NELLEN,
MEMBERS OF THE AICPA INDIVIDUAL TAXATION TAX TECHNICAL RESOURCE PANEL

This article covers recent significant developments affecting taxation of individuals, including cases, regulations, and legislative changes. The items are arranged in Code section order.

Sec. 1: Tax Imposed

Kiddie tax: The Small Business and Work Opportunity Tax Act of 2007, P.L. 110-28, increased the age requirements for Sec. 1(g) (the kiddie tax) effective for tax years after May 2007. The new law expands the application of the kiddie tax to investment income of children under age 19 (under age 24 if a student). Specifically, the kiddie tax now applies to a child aged 19-23 if:

1. The child is a full-time student before the close of the tax year; and
2. The child's earned income does not exceed one-half of his or her support.

Foreign dividends: Notice 2006-101¹ gives an expanded list of countries with treaties that satisfy the requirements of Sec. 1(h)(11)(C)(i), allowing for dividends paid by qualified foreign corporations in such countries to be taxed as capital gains. The notice lists 55 treaties. Two new treaties—those with Sri Lanka and Bangladesh—are on the list. A 2004 protocol to the

U.S.-Barbados treaty has made that treaty satisfactory, and it too is now on the list. Three U.S. tax treaties do not meet the requirements: those with Bermuda, the Netherlands Antilles, and the U.S.S.R. (which applies to certain former Soviet republics).

Sec. 21: Child and Dependent Care Credit

Final regulations on the child and dependent care credit (TD 9354), issued effective August 14, 2007, closely follow the proposed regulations issued on May 24, 2006 (REG-139059-02). The final regulations include extensive examples that clarify who is a qualifying individual, what household services and educational programs may be included in employment-related expenses, and the timing and computation of employment-related expenses for child and dependent care credit purposes. For example, the regulations make it clear that expenses for a child in kindergarten or higher grades and for summer school, tutoring, and overnight camps do not qualify for the credit, but day programs such as math camp or computer camp may.

In determining what constitutes a "short, temporary absence" from work for purposes of the child and dependent

care credit, the regulations provide a safe harbor that treats an absence from work of no more than two consecutive weeks as such. Unlike the proposed regulations, this safe harbor is not limited to taxpayers who pay for the dependent care on a weekly, monthly, or annual basis.²

Sec. 53: Credit for Prior Year Minimum Tax Liability

Some individuals have large amounts of minimum tax credit (MTC) for alternative minimum tax (AMT) paid in prior years that was attributable to deferral adjustments, frequently caused by AMT resulting from the exercise of incentive stock options. Because the MTC is a nonrefundable credit, and because of the limitations of Sec. 53(c), many of these individuals are unlikely to ever be able to use much of their MTC.

New Sec. 53(e)(4), enacted by the Tax Relief and Health Care Act of 2006, P.L. 109-432, makes the MTC refundable for individuals with long-term unused credits. The change applies to tax years beginning after December 20, 2006, but before January 1, 2013. Taxpayers who have long-term unused MTCs are entitled to an MTC equal to the greater of the AMT refundable

¹ Notice 2006-101, 2006-47 IRB 930.

² For more on these regulations, see Cook, "Regulations Provide Guidance on Child and Dependent Care Credit," p. 86.

credit amount or the amount of allowable MTC under the preexisting Sec. 53(c) limitations, but subject to adjusted gross income phaseouts.

Sec. 61: Gross Income

Tax gap: In August 2007, the Service released its report on the tax gap, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*. The report, which builds on an earlier report, *Comprehensive Strategy for Reducing the Tax Gap* (September 2006), lists actions the IRS is taking and may take to reduce the tax gap.

Recommendations in the report include:

- Require more information reporting, such as for payments of \$600 or more to corporations, basis reporting by stockbrokers, reporting by auction houses, or reporting by merchants who process credit card receipts for businesses.
- Require certified taxpayer identification numbers from contractors.
- Increase information matching and audit activity for individuals living abroad.
- Do a better job of selecting returns for audit.
- Improve taxpayer service.
- Work with Congress to further simplify the law regarding the uniform definition of a child, EITC eligibility, and the refundable child tax credit.
- Work with other government agencies to address employment tax schemes.
- Create and widely distribute fact sheets on areas of high noncompliance.
- Create educational phone messages for taxpayers to listen to while on hold.
- Find ways to educate first-time business filers.

The IRS website has links to the tax gap reports and monthly fact sheets on various areas of concern.³

Retirement plan distributions: In Letter Ruling 200724008,⁴ the taxpayer, a

public school district, created an early retirement incentive plan to allow eligible employees to elect one of two distribution options:

1. Retiree health benefits of up to a certain amount per year; or
2. A one-time payment of a set amount per unused sick day (not to exceed 200 accumulated unused sick days), plus a retirement bonus.

Under the plan, when employees notify the school district of their retirement they must make an irrevocable election as to which option they want.

The IRS ruled that employees who elect option 2 must include the entire amount in their gross income per Sec. 61. Employees who elect option 1 must be treated as if they had elected option 2 and include in gross income the amount they could have received if they had elected option 2. The Service relied on its Rev. Ruls. 75-539 and 2005-24.⁵

Sec. 83: Property Transferred in Connection with Performance of Services

Courts continue to rule that taxpayers must report the spread on a stock option's exercise as income at the exercise date because that is when they became the beneficial owners of the shares, not when the associated margin loan was later repaid.⁶

Sec. 104: Compensation for Injuries or Sickness

In *Murphy*,⁷ the taxpayer received compensatory damages for emotional distress and loss of reputation. She argued that the award was not taxable for three reasons: (1) it was excludible under Sec. 104 as received for a physical injury; (2) it is not gross income under Sec. 61; and (3) taxing the award imposes an unapportioned direct tax on the taxpayer, which violates Article I, Section 9, of the U.S. Constitution.

The court disagreed with all three of Murphy's arguments:

1. While there may have been physical injuries, the court found that Murphy's award was not made because of them. "Murphy's damages were not 'awarded by reason of, or because of, . . . [physical] personal injuries.'"⁸

2. According to the court, under any theory of gross income and Sec. 61, including accession to wealth, Murphy's damages are taxable. An argument that the award recompenses her for injury to human capital failed because she had no basis in her human capital, and damages for non-physical personal injuries have always been held to be income. In addition, although "Congress cannot make a thing income which is not so in fact,"⁹ the court held that "it can label a thing income and tax it, so long as it acts within its constitutional authority, which includes not only the Sixteenth Amendment but also Article I, Sections 8 and 9."

3. In analyzing guidance on direct taxes and uniformity, the court found no violation of uniformity from including the damages in Murphy's income. The court framed the question as, "Is a tax upon this particular kind of transaction equivalent to a tax upon a person or his property?" The court noted that the tax was imposed only after Murphy received the award; thus it is "laid upon a transaction" rather than ownership, such as of one's human capital.

The court further stated:

Whether she profited is irrelevant, however, to whether a tax upon an award of damages is a direct tax requiring apportionment; profit is relevant only to whether, if it is a direct tax, it nevertheless need not be apportioned because the object of the tax is income within the meaning of the Sixteenth Amendment.

³ See www.irs.gov/newsroom/article/0,,id=158619,00.html.

⁴ IRS Letter Ruling 200724008 (6/15/07).

⁵ Rev. Rul. 75-539, 1975-2 CB 45, and Rev. Rul. 2005-24, 2005-1 CB 892.

⁶ See *Palahnik*, 475 F3d 1380 (Fed. Cir. 2007), and *Cidale*, 475 F3d 685 (5th Cir. 2007). See also *Racine*, 493 F3d 777 (7th Cir. 2007) (the exercise of

nonstatutory employee stock options financed by margin loan was taxable in the exercise year).

⁷ *Murphy*, 493 F3d 170 (D.C. Cir. 2007).

⁸ Quoting *O'Gilvie*, 519 US 79, 83 (1996).

⁹ *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 US 110, 114 (1925).

The Supreme Court has held several times that a tax not related to business activity can still be an excise tax. The court considered the tax at issue similar to those. The court referred to *Bromley v. McCaughn*¹⁰ as relevant. In that case, a gift tax was held to be an excise tax—the Supreme Court noted that it was “a tax laid only upon the exercise of a single one of those powers incident to ownership,”¹¹ which distinguished it from “a tax which falls upon the owner merely because he is owner, regardless of the use or disposition made of his property.”¹² The court considered a gift to be the functional equivalent of a below-market sale, and therefore if

a gift tax, or a tax upon a below-market sale, is a tax laid not upon ownership but upon the exercise of a power “incident to ownership,” then a tax upon the sale of property at fair market value is similarly laid upon an incidental power and not upon ownership, and hence is an excise.

The court concluded:

[E]ven if we were to accept Murphy’s argument that the human capital concept is reflected in the Sixteenth Amendment, a tax upon the involuntary conversion of that capital would still be an excise and not subject to the requirement of apportionment.

With regard to uniformity, the court noted that a “tax is uniform when it operates with the same force and effect in every place where the subject of it is found.”¹³ The court held that “the tax upon the award is an excise and not a direct tax subject to the apportionment requirement of Article I, Section 9 of the Constitution. The tax is uniform throughout the United States and therefore passes constitutional muster.”

In *Ballmer*,¹⁴ the taxpayer received about \$330,000 in damages in a suit against the California Franchise Tax

Board. Damages included an amount for emotional distress. The taxpayer argued that this was not income under Sec. 61 because it was a recovery for damage to human capital. Thus, the taxpayer argued, Sec. 104 was not relevant because the amount received was not income in the first place. The Tax Court noted that this was the same argument raised in *Murphy*. The court ruled that all of the damages received, including recovery of legal fees, were included in gross income and the legal fees were a miscellaneous itemized deduction.

Sec. 152: Dependent Defined

The Service has issued proposed regulations on the rules governing a “qualifying child” for parents who are divorced or legally separated or who live apart at all times during the last six months of the year (REG-149856-03). Under Sec. 152(e)(4)(A), a “custodial parent” is “the parent having custody for the greater portion of the calendar year.” Prop. Regs. Sec. 1.152-4(c) provides that the determination is made by counting the number of nights the child spends with a parent. If a child is temporarily absent any night, the child is treated as residing with the parent with whom he or she would otherwise have resided. Unlike prior law, the divorce decree or similar agreement is not used to determine custody.

Under Prop. Regs. Sec. 1.152-4(d), a written declaration required by Sec. 152(e)(2) must:

- Constitute the custodial parent’s unconditional release of the claim for the year or years for which the declaration is effective;
- Name the noncustodial parent;
- Specify the year or years to which it applies;
- Not be a court order or decree; and
- Be submitted on Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or otherwise conform to its substance.

Sec. 162: Trade or Business Expenses

In *Settimo*,¹⁵ the Tax Court ruled that child care expenses paid for a spouse-employee of an S corporation’s owner were not deductible as an ordinary and necessary expense because they were not directly related to the company’s business. The taxpayer relied on Rev. Rul. 73-348,¹⁶ which does allow for such a deduction. However, in this case, the court felt that payment of the expenses was not directly related because only the child care expenses for the sole owner and his spouse were paid. The corporation had other employees during the two years in question. Unanswered is whether the expenses would have been allowed if the sole owner and his spouse were the only employees of the corporation.

Two separate Tax Court memorandum decisions denied attempts to deduct unreimbursed employee expenses under specific circumstances. In *Stockwell*,¹⁷ the taxpayer chose to accept out-of-town assignments rather than be laid off from his job. These assignments were for an indefinite period of time. The court ruled that the taxpayer no longer had a business purpose for maintaining residence in his home city because he no longer had a job waiting for him to return to. Therefore, he was not “away from home” while on these assignments and his deductions for vehicle, meal, and lodging expenses were properly denied.

In *Contreras*,¹⁸ the court strengthened the burden of proof required to show that expenses could not be reimbursed by an employer. As a cost-cutting measure, the taxpayer’s employer instituted “travel freezes” during several time periods. During these periods, expenses that would normally be automatically reimbursed required the specific approval of a vice president. The taxpayer incurred valid expenses during these travel freeze periods and attempted to deduct them

¹⁰ *Bromley v. McCaughn*, 280 US 124 (1929).

¹¹ *Id.* at 136.

¹² *Id.* at 137.

¹³ Quoting *Ptasynski*, 462 US 74, 82 (1983).

¹⁴ *Ballmer*, TC Memo 2007-295.

¹⁵ *Settimo*, TC Memo 2006-261.

¹⁶ Rev. Rul. 73-348, 1973-2 CB 31.

¹⁷ *Stockwell*, TC Memo 2007-149.

¹⁸ *Contreras*, TC Memo 2007-63.

as unreimbursed employee expenses. He did not submit them to his employer (normal procedures were suspended during the freeze periods) or attempt in any way to get approval from a vice president. The court found that the burden was on the taxpayer to prove that a vice president would not have approved the expenses and denied the deductions.

Sec. 165: Losses

In *Arnold*,¹⁹ the taxpayers, a husband and wife, wired money to Orion Venture in the West Indies. Orion was to invest the funds in foreign currency trades and yield returns of 6%–8% per month. (The court noted that this was likely a Ponzi scheme.) Orion reported gains to its customers, but the taxpayers did not report them on their return. In December 2003, the taxpayers received a letter from the U.S. Postal Inspection Service notifying them that they may have been victims of a fraud. The taxpayers then tried to recover funds from Orion. They also saw a newspaper story noting that Orion's founder was suspected of misusing Orion's money. At trial, the taxpayers argued that they had a \$20,000 capital loss from Orion.

The court denied the loss under Sec. 165(g) because the taxpayers did not show that their loss was from a "security," that they had a loss, and, if so, that it was for the years at issue. The court noted in a footnote that the taxpayers raised the security loss issue at trial, rather than the issue of a theft loss, so theft loss was not discussed in the opinion.

Sec. 170: Charitable Contributions and Gifts

Effective with tax year 2007, the recordkeeping requirements that formerly applied to cash contributions over \$250 have been extended to cover all cash contributions regardless of

amount (Sec. 170(f)(17)). Basically, this means that a bank statement, canceled check, credit card statement, or written acknowledgment from the charity will be required for all cash contributions. This may surprise many taxpayers who are used to deducting the cash they leave each week in a church collection plate or drop in a basket when attending a 12-step recovery program meeting such as Alcoholics Anonymous.

Tax year 2007 is the last opportunity (unless extended by Congress) to make a charitable contribution directly from an IRA (Sec. 408(d)(8)(F)). When individuals who are required to withdraw a minimum required distribution (MRD) direct their IRA trustees to distribute funds directly to a charitable organization, the amount contributed is non-taxable income and counts toward their MRD amount (up to \$100,000). Of course, they cannot also take an itemized deduction under Sec. 170 for this amount. The IRS recently indicated that a check payable to the charity may be sent to the taxpayer, forwarded by him or her to the charity, and still be considered a direct distribution to the charity.²⁰ This provision is especially useful to retired individuals who do not itemize their deductions.

Sec. 195: Start-Up Expenditures; Sec. 212: Expenses for the Production of Income

In *Toth*,²¹ the Tax Court ruled that expenses incurred for a Sec. 212 activity that was later converted into a trade or business were not required to be capitalized under Sec. 195. There was no dispute as to whether the expenses were ordinary and necessary business expenses. However, the IRS claimed that the taxpayer had always intended to eventually convert the activity (horse training and boarding) into a business. Three years after first engaging in the activity for profit and a period of

slow growth, the taxpayer retired from her job and turned the activity into a full-time business. The IRS took the position that expenses incurred prior to that time were start-up expenses for the trade or business and must be capitalized. The court ruled that the intent of the Code and prior case law was that deductions under Secs. 162 and 212 are intended to be on equal footing. It also construed start-up expenses to denote capital and not ordinary expenses and allowed the deductions under Sec. 212.

Sec. 6015: Relief from Joint and Several Liability on Joint Return

The IRS issued revised Form 8857, Request for Innocent Spouse Relief. The new form will ask for more information early in the process, eliminating the need for follow-up letters requesting further information. The revisions will result in faster determinations and lower government costs. The new form will be easier to understand and will educate taxpayers about the innocent spouse relief process.

In an innocent spouse case decided by the Tax Court, the major issue was whether the petitioner could seek innocent spouse relief from unpaid joint tax liabilities through the small tax case procedures authorized by Sec. 7463(f)(1).²² The court held that the \$50,000 limit on qualifying for the use of small tax case procedures refers to the total amount of relief sought, including tax plus accrued interest and penalties, and that the limit applies to the aggregate amount for all tax years involved. While the relief the taxpayer sought was less than \$50,000 for each year in contention, it in total exceeded \$50,000 at the time the taxpayer filed her petition; therefore, the taxpayer could not use the small case procedures.

TTA

¹⁹ *Arnold*, TC Memo 2007-168.

²⁰ Notice 2007-7, 2007-5 IRB 395.

²¹ *Toth*, 128 TC No. 1 (2007).

²² *Petrane*, 129 TC No. 1 (2007).

Copyright of Tax Adviser is the property of American Institute of Certified Public Accountants and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.